# Spiraling Down

*A View of Poland at the End of 2001*

We will try to step back and take a long view, look at the forest and not the trees, to make sense out of what is going on in Poland at present. It is not easy.

The new Polish government, dominated by the Social Democratic Left (SLD)[1], is struggling to find its way. Important to those who follow the energy sector in particular, and infrastructure privatization and restructuring in general, is the present tug-of-war between ideology and reality.

On the side of ideology is the Minister of the State Treasury, Wies»aw Kaczmarek, who has been consistently critical of the former (AWS) government's privatization and restructuring policies. Minister Kaczmarek has two basic complaints, it would seem, with the previous policies:

! privatization was previously being conducted to maximize, and accelerate, revenues to the State budget with little thought to the implications for the country or the economy of the actions, and with little benefit accruing to the companies undergoing privatization[2]; and

! the companies were not properly prepared, nor were their industries, for the privatization program.

While the latter complaint has often been used in Poland as an excuse for resisting change, in this case we accept Mr. Kaczmarek's sincerity, although we are not enthusiastic about his definition of a properly prepared industry. We will return to that point.

On the first complaint, Mr. Kaczmarek is probably right - in theory. The proceeds from the sale of state-owned assets should not be used for current budgetary purposes. What that ignores is that they have been for some years, and spending habits have come to rely on income from these sources.

On the side of reality is the Minister of Finance, Marek Belka, who is staring at huge budget deficit problems and looking for money anywhere, and everywhere, he can find it. His task of trying to bring next year's budget deficit down to acceptable levels is most unenviable. Privatization revenues cannot fix the problem, but they can help. Most other alternatives for bringing the budget closer to balance are even more politically unattractive.

By definition there are two ways to close the deficit gap: reduce outflows and increase inflows. Reducing outflows means cutting expenditures, which in Poland is especially difficult. Leszek Balcerowicz, when he was Minister of Finance, made the point that Poland had one of the highest ratios of entitlement programs to total expenditures of any OECD country, a point recently reiterated by Minister Belka. Simply stated, there is too little over which the government has discretion. Therefore, to cut expenses, the government must ask the parliament to remove or reduce sharply entitlement programs. This opens the government up to charges of "balancing the budget on the backs of the poor," because all these programs are social in nature. Social dissatisfaction is likely to grow if this is the chosen route.

But, the prospects for cutting expenses are worse than it might seem. Much is made by economists of Poland's "generous social programs". However, from the viewpoint of the average Pole, the "generous"programs are inadequate and inefficient. In short, Poland spends an inordinate portion of its national budget on social programs that the public finds seriously short of the mark. This is especially true of the health care, transportation and education systems. Even if the programs were well run, delivering lavish services to the public, the Polish public has been conditioned by years of dogma to expect cradle-to-grave social programs to cover almost every need. The public expects such programs as a matter of right, and would fiercely oppose significant cutbacks. Therefore, cutting social programs will take enormous effort and political capital, capital this new SLD government does not have. Making social programs more efficient, thus saving money and improving the quality of service, is an imperative. But it will take time, and it will take great leadership to rid the systems of the bad habits, ingrained bureaucracy, and even corruption, that make these programs as ineffective as they presently are. As much as such improvements are urgently needed, they are not an answer to the immediate problems of the deficit, and so are not likely to get much attention.

Finance Minister Belka is trying to increase inflows as well. Considering that Poland is already a very highly taxed country, raising taxes is never popular or productive. Most of the tax increases being thought of are regressive in nature. Given the stagnating nature of the Polish economy, exacerbated by the worsening world economy, regressive policies are especially unwelcome and inappropriate at the moment.

The third, longer term, way to close the budget gap is for the country to grow its way out of the problem. Here, the ongoing disagreement between the government (both AWS and the SLD) and the National Bank of Poland's Monetary Policy Committee is a problem. Poland has some of the highest real rates of interest in the OECD as a result of the conscious policy of the NBP to reduce inflation. While the inflation battle has probably been won, the growth of the economy has been the price. Business, especially small business, is simply unable to borrow money at a viable cost, hence growth has been strongly restrained. Interest rates are dropping, but not enough to provide any kind of strong economic stimulus as they are dropping elsewhere as well. Poland's real rates of interest remain among the highest in the OECD world.

Another factor in this nasty equation is often glossed over by economists and politicians: maintenance of the "family silver." This is especially applicable to the energy sector, and to heavy industry privatization programs.

For many years, Polish politicians have been stating their opposition to "selling (or giving away) the family silver." By "family silver" they generally refer to the great state-owned enterprises that were the pride of the Communist dogma: steel mills, coal mines, power plants, chemical plants, railroads, airlines, and the like. In short, the "family silver" refers to the heavy industry that employed lots of people, and were massive engineering achievements.

What the politicians have never been willing to admit, whether to the public or even to themselves, is that the family silver was tarnished, damaged, and, perhaps, was never silver at all.

The cost of maintaining this silver, however, has reached sterling proportions. The previous government, reluctant to face reality, came up with the idea of "holdings." That is, two or three virtually bankrupt and badly bleeding companies, to which the banks were no longer willing to lend money, were put into a new, state-owned holding company, capitalized with some shares in other state-owned companies that were doing somewhat better. The new holding companies were then touted to the public and to financial institutions as "restructured industry" with the expectation that new debt could be added to keep it all going.

In the energy sector the prime example is the "Southern Energy Consortium" (PKE). This is a company built around the successful Jaworzno power station and is starting to become a conglomerate that has acquired additional power generation companies, and is hoping to add electricity distribution and a portfolio of coal mines. In short, the idea is to create regional monopolies that are vertically integrated from the coal face to the retail customer's fuse box. The idea was strongly supported by the former Minister of the Economy (Steinhoff) and, sadly, Treasury Minister Kaczmarek seems to think it is a great idea. Thus, this idea seems to be attaining the stature of "proper preparation of the sector."

The energy sector more recently, along with the rest of the country, has been savaged by political pork barreling. Since the government still owns most of the heavy industry, it has the power to replace supervisory and management board personnel for political reasons; and it does.

A recent storm arose over Minister Kaczmarek's dismissal of the entire management board of Polish Oil & Gas Company ("PGNiG"). This has had the effect of bringing the restructuring of PGNiG to a screeching halt, and will probably delay by at least a year any strategic decision making at PGNiG at all. This is unfortunate for a company that is in dire need of making some important strategic business decisions about how it will develop and structure its business for the future. Sadly, we might note that hampering PGNiG in the formation of effective business development strategies is entirely consistent with the unstated, but consistent from government to government, policy of protecting the coal mines from all threats to business as usual.

On a broader base throughout the country, we cannot see that it is helpful to an economy in trouble to have a significant portion of the GDP being infected by management paralysis brought on by the wholesale replacement of managers for political reasons.

In summary, all these factors combine to bring privatization in particular, and economic expansion in general, to a crawl (if not a full stop) for the near future. No one is complaining for there is no love of privatization either in the corridors of the Social Democratic Left, or even on the street. At best, privatization, especially of the family silver, has been publicly seen as a necessary evil, if necessary at all.

**Is there a "light at the end of the tunnel?"** For years we have been advising our readers, and clients, to have heart, that Poland, despite appearances to the contrary, is going to be a place one will eventually be happy to have invested in. Eventually. But, when?

We believe, as committed free-market business people, that Poland is making a mistake to flirt so deeply with state ownership and strongly Socialist mechanisms. Our contacts with Polish people convince us that a substantial portion of the population are not taken in by the Socialist rhetoric. There is already in place the beginnings of a strong middle class in Poland, which is an entrepreneurial middle class, not a bureaucratic middle class.

So perhaps, the present economic blood-letting, as painful as it is and will be for the Polish public for a while, is a necessary evil. Perhaps, the romance with Socialism and state oriented solutions will prove an infatuation brought up short by reality.

We remember the words of Ronald Reagan when he said that "government is not the solution, government is the problem." At present in Poland, the public seems to be willing to give the government the chance to prove it is the solution, not the problem. The economic realities seem to be calling for a different view.

But, for the public to see that, the government will have to fail, and fail miserably, first. We believe this will happen. In short, things probably will get better, but first they must get worse.

There are those who argue with us, and point to France as an example that proves that government can be the solution. While that is the way it might seem, we don't accept the example as applicable. One should remember that France's present state-owned giants were mostly free enterprise successes that were nationalized. Poland does not have such successes off which to build a viable state-owned sector. Poland is trying to build a state-owned sector on a foundation of mud and ashes, not the solid foundation the French were fortunate to have to start with.

So, the issue of investing in Poland is timing. That we leave up to the individual investor. The timing will be different for different sectors. But generally, we think that it is impossible to "bottom fish." As long as stakes can be taken that will not become unsupportable cash drains, we think it's not a bad idea to consider taking a position now, but very carefully. Long term, we remain bullish on Poland.

## Notes:

1. Please see our brief report on the elections for more information.

2. We can illustrate this with an example with which we are familiar. It involves the privatization of a company that required considerable modernization and renovation, but lacked the capital resources to do this. The company was offered for privatization by the State Treasury. The bid structure called for two elements to the pricing: (1) the pricing of an immediate payment *to the state treasury* for shares in the company; and (2) the pricing of investor's plans to increase capital and conduct modernization of the company. There were two finalists: the bid of one had a price for the shares roughly twice the price of the second bid - **but**, the total value of the second bidder's package, including the modernization of the company, was more than twice the total value of the first bidder's offer. Nonetheless, the first bidder was selected by the Treasury.